



1
2 Signed and Filed: January 22, 2010
3
4
5
6
7

8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

THOMAS E. CARLSON
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re) Case No. 08-32226 TEC
2712 MISSION PARTNERS, L.P.,) Chapter 11
Debtor.)
)

MEMORANDUM RE OBJECTIONS TO DISCLOSURE STATEMENTS AND SECURED
CREDITORS' MOTION FOR RELIEF FROM STAY

On January 11, 2010, the court held a hearing regarding three matters: the adequacy of the disclosure statement filed by Debtor; the adequacy of the disclosure statement filed by unsecured creditor 600 Alabama Partners LLC; and the joint motion of two secured creditors for relief from the automatic stay. Scott H. McNutt and Marianne Dickson appeared for Debtor. Merle C. Meyers appeared for David Bradlow, the chapter 11 trustee of 600 Alabama Partners LLC (600 Alabama). Jeanne M. Jorgensen appeared for secured creditor Los Angeles Federal Credit Union (LAFCU). Henry Lerner appeared for secured creditor Redwood Mortgage Investors

MEMO RE DISC. STMT. OBJECTIONS
AND STAY-RELIEF MOTIONS

-1-

1 VIII (Redwood Mortgage). Timothy J. Gorry appeared for unsecured
2 creditor Gorry, Meyer & Rudd, LLP (Gorry). Hutchinson B. Meltzer
3 appeared for MKA Capital Group, Inc. (MKA).

4 Upon due consideration, and for the reasons stated below, the
5 court declines to approve either disclosure statement, because
6 neither plan can be confirmed. The court conditions the
7 continuation of the automatic stay upon an effort to sell promptly
8 the affected real property.

9

10 FACTS

11 Debtor is a limited partnership that owns an office building
12 at 2712 Mission Street in San Francisco (the Property). The entire
13 building is leased to the City and County of San Francisco (the
14 City). The initial term of the lease expires in twenty months
15 (September 30, 2011). The lease affords the City the option to
16 extend the lease term for an additional five-year period. The City
17 must exercise that option by April 3, 2011. The rent payable
18 during the five-year extension is the greater of 95 percent of the
19 current market rate or the rent during the previous term of the
20 lease.

21 The Property is subject to three promissory notes secured by
22 deeds of trust. The first deed of trust, which is held by LAFCU,
23 currently has a balance of approximately \$9.6 million. The second
24 deed of trust, which is held by Redwood Mortgage, has a balance of
25 approximately \$1.2 million. The third deed of trust, which is held
26 by MKA, currently has a balance of approximately \$14 million. Both
27 Debtor and 600 Alabama contend that the MKA deed of trust is
28 avoidable as a fraudulent conveyance, and it appears that MKA may

1 agree to release its lien upon payment of \$50,000. There is a lien
2 for property taxes in the amount of \$200,000. An appraisal
3 obtained by Debtor indicates that the Property was worth
4 approximately \$13.3 million in March 2009. An appraisal obtained
5 by LAFCU indicates that the Property was worth approximately \$11.2
6 million in October 2009. Debtor has equity in the Property only if
7 the value is at least \$11.1 million and the MKA deed of trust is
8 avoidable.

9 Allowed general unsecured claims total approximately \$1.1
10 million. The largest of these claims are held by 600 Alabama
11 (\$850,000),¹ and Gorry (\$220,000).²

12 Debtor filed this chapter 11 case on November 20, 2008 to stay
13 a state-court action by LAFCU seeking appointment of a receiver.
14 Debtor was in default under the first deed of trust, because it
15 fell behind in its monthly mortgage payments, and because it
16 breached a covenant prohibiting additional encumbrances.

17 The central facts of this case are these. The current lease,
18 executed during the 2000-2008 real estate boom, provides sufficient
19 rental income to make debt service payments to the first and second
20 deeds of trust at the non-default rate. All parties agree that
21 following the real estate crash of 2008, the rent specified in the
22

23 ¹ Debtor objected to the \$1.0 million proof of claim filed by
24 600 Alabama, and the dispute was settled on the day of trial with
25 600 Alabama to have an allowed general unsecured claim in the
amount of \$850,000. Debtor later moved to set aside that
settlement, but the court denied that motion by order signed on
January 22, 2010.

26 ² Gorry now asserts a claim of \$485,256, but did not file a
27 timely proof of claim. At a hearing held on or about May 22, 2009,
28 the court determined that the estate was estopped from objecting to
the timeliness of any claim up to \$220,000, because Debtor proposed
to pay Gorry that amount in a plan filed prior to the claims bar
date.

1 current lease is substantially above the current market rate. The
2 initial term of the current lease expires in less than two years.
3 All parties agree that if the Property is leased at a market rate
4 at that time, the rental income will not be sufficient to pay debt
5 service on the first and second deeds of trust. The City has an
6 option, which it must exercise by April 3, 2011, to extend the
7 current lease for five years at the current rent. Debtor and 600
8 Alabama suggest that the City will exercise this option, because of
9 the expense and inconvenience of moving to a new location. An
10 economist would suggest that the lessor and tenant will likely
11 share whatever savings the City would enjoy by avoiding a move, and
12 that at the end of the current term, the parties will negotiate a
13 rent between the current above-market rent and the market rent. In
14 the face of such logic, Debtor and 600 Alabama could show that the
15 City will exercise the option to extend a lease requiring it to pay
16 above-market rent only through a statement to that effect from City
17 officials, which those officials have no interest in providing.

18 LAFCU and Redwood Mortgage moved for relief from stay on the
19 basis that: (1) Debtor has no equity in the Property; and (2) that
20 the Property is not necessary to an effective reorganization,
21 because Debtor is unable to confirm a plan under which it retains
22 the Property. Debtor has previously filed three chapter 11 plans,
23 none of which have been confirmed. The court determined that
24 sufficient time had passed since the filing of the petition that
25 relief from stay should be granted unless a plan was promptly
26 confirmed. Debtor and 600 Alabama each filed a chapter 11 plan and
27 accompanying disclosure statement within the deadline set by the
28 court.

MEMO RE DISC. STMT. OBJECTIONS
AND STAY-RELIEF MOTIONS

-4-

1 The chapter 11 plan filed by Debtor provides for the infusion
2 of \$1.7 million, which will be used to reinstate the first and
3 second deeds of trust, extinguish the third deed of trust for an
4 agreed-upon payment of \$50,000, and pay \$520,460 to general
5 unsecured creditors (less than 50 percent of the allowed claims).
6 The plan and disclosure statement provide that LAFCU and Redwood
7 Mortgage are unimpaired, and that Debtor therefore need not pay the
8 default rate of interest specified in the promissory notes. See In
9 re Entz-White Lumber & Supply, Inc., 850 F.2d 1338, 1342 (9th Cir.
10 1988).

11 The chapter 11 plan filed by 600 Alabama provides for the
12 eventual sale of the Property. LAFCU and Redwood Mortgage are to
13 retain their liens on the Property, but the plan does not provide
14 for them to retain their liens on all rents and profits. Rental
15 income is to be used to pay debt service to LAFCU and Redwood
16 Mortgage at a market rate to be determined by the court at some
17 later date. The plan is to be administered by a Plan Committee,
18 whose expenses are to be paid from unencumbered assets (which
19 include rental income not necessary to pay current debt service).
20 The Committee has five years from the date of confirmation to sell
21 the Property.

22

23 DISCUSSION

24 A. Debtor's Plan and Disclosure Statement

25 LAFCU, Redwood Mortgage, 600 Alabama, and Gorry object to
26 approval of Debtor's disclosure statement on numerous grounds.
27 Among the objections is that Debtor's chapter 11 plan cannot be
28 confirmed. Although at least some of the other objections may have

1 merit, the court need not address those objections, because it is
2 apparent that Debtor's plan cannot be confirmed.

3 First, Debtor's plan does not satisfy the absolute priority
4 rule. The plan does not provide for payment in full of the allowed
5 claims of general unsecured creditors. Because the claim of 600
6 Alabama represents more than one-half in amount of the allowed
7 general unsecured claims, and because 600 Alabama objects to
8 confirmation of the plan, general unsecured creditors do not accept
9 the plan. 11 U.S.C. § 1126(c). Because general unsecured
10 creditors do not accept the plan and are not paid in full, and
11 because the plan provides that the sole equity holder retains an
12 interest in Debtor and the Property in respect of his existing
13 equity interest, the plan does not satisfy the absolute priority
14 rule.³ 11 U.S.C. § 1129(b)(2)(B).

15 Second, Debtor's plan cannot be confirmed because it
16 improperly classifies LAFCU as unimpaired. To leave LAFCU
17 unimpaired, the plan must cure all defaults other than those
18 specified in section 365(b)(2). 11 U.S.C. § 1124(2)(A). Debtor's
19 plan does not propose to cure Debtor's breach of the covenant in
20 the LAFCU note barring junior encumbrances. Debtor argues that
21 section 365(b)(2)(D) excuses the cure of virtually all non-monetary
22 defaults, including the due-on-encumbrance clause at issue here,
23 citing In re Bankvest Capital Corp., 360 F.3d 291 (1st Cir. 2004).
24 Debtor's reliance on Bankvest is misplaced and represents a
25

26
27 ³ The sole equity holder in Debtor, Mr. Kilroy, would retain
28 an interest in Debtor (and thereby in the Property) "in respect of"
his current equity interest, because under Debtor's plan, Mr.
Kilroy alone has the right to make the proposed "new value"
interest and thereby retain ownership of Debtor and the Property.
See Debtor's 4th Am. Disc. Stmt. at 19.

1 significant breach of Debtor's counsel's duty of candor to this
2 court.

3 Bankvest did find that section 362(b)(2)(D) excused a debtor
4 from curing most kinds of non-monetary defaults. The court
5 construed the statutory language excusing the cure of any "penalty
6 rate or provision" to mean in substance: any penalty rate, or any
7 provision regarding non-monetary default. Id. at 300-01. Under
8 Bankvest, Debtor would not be required to cure the due-on-
9 encumbrance provision to satisfy section 1124(2)(A).

10 The problem is that Bankvest acknowledges that the Ninth
11 Circuit had ruled otherwise, and that Bankvest has since been
12 overruled by statutory amendments applicable to the present case.
13 The Bankvest decision expressly noted that the Ninth Circuit had
14 construed the language of section 362(b)(2)(D) to mean in
15 substance: any penalty rate, or any penalty provision regarding a
16 non-monetary default. Id. at 296-98 (citing In re Claremont
17 Acquisition Corp., Inc., 113 F.3d 1029 (9th Cir. 1997)).⁴ Claremont
18 also held that the term penalty rate means a default rate of
19 interest, and that penalty provision means a liquidated damages
20 provision. Claremont, 113 F.3d at 1034. The due-on-encumbrance
21 clause at issue here is not a penalty rate or penalty provision
22 within the meaning given to those terms in Claremont. Any question
23 as to whether Claremont or Bankvest is controlling was resolved in
24 the 2005 amendments to the Bankruptcy Code. Section 365(b)(2)(D)
25 now provides that Debtor is excused only from curing a "penalty
26 rate or penalty provision," expressly adopting the Ninth's Circuit

27
28 ⁴ The Claremont decision was overruled by statute to excuse
non-curable, non-monetary defaults regarding non-residential real
property leases. 11 U.S.C. § 365(b)(1)(A). That amendment has no
effect upon the present case.

1 Claremont decision.⁵ Thus, following the amendments, section
2 1124(2)(A) requires the cure of almost all non-monetary defaults.
3 In re Empire Equities Capital Corp., 405 B.R. 687, 690-91 (Bankr.
4 S.D.N.Y. 2009).

5 The discussion of impairment in the Debtor's disclosure
6 statement cited only Bankvest. It did not in any way acknowledge
7 Claremont or the subsequent amendment to section 365(b)(2)(D).

8 This appears to be a serious breach of counsel's duty of candor.⁶

9 The practical effect of the rejection of Debtor's plan by
10 general unsecured creditors and the plan's failure to leave LAFCU
11 unimpaired, is that Debtor must raise substantially more than \$1.7
12 million to confirm its plan. To satisfy the absolute priority rule
13 by paying 600 Alabama in full, Debtor would have to raise an
14 additional \$575,000. To leave LAFCU unimpaired by curing the due-
15 on-encumbrance clause, Debtor would have to raise yet another \$1.2
16 million to repay the second deed of trust.

17 It is inappropriate to afford Debtor additional time to amend
18 its plan and disclosure statement. The current plan is Debtor's
19 fourth. Debtor was unable to confirm its first three plans. The
20 case has been pending for fourteen months. To confirm a plan in
21 which Debtor retains the Property, Debtor would have to raise
22 substantially more than it proposed to do in its current plan, and
23 the current plan and disclosure statement provide no credible

24

25

26

27 ⁵ The amendment to section 365(b)(2)(D) is applicable to all
28 cases filed after October 17, 2005. The present case was filed on
November 20, 2008.

⁶ The court will address this apparent ethical violation
through a separate order to show cause.

1 detail regarding the source of the \$1.7 million investment proposed
2 in the current plan.

3 B. The Plan and Disclosure Statement filed by 600 Alabama
4 LAFCU, Redwood Mortgage, and Gorry object on numerous grounds
5 to approval of the disclosure statement filed by 600 Alabama.
6 Among the objections is that the chapter 11 plan filed by 600
7 Alabama cannot be confirmed. The court agrees, and determines that
8 the disclosure statement should not be approved because the plan
9 cannot be confirmed.

10 Secured creditors LAFCU and Redwood Mortgage do not accept the
11 600 Alabama plan. The plan can be confirmed over their objection
12 only if the plan is "fair and equitable" with respect to LAFCU and
13 Redwood Mortgage. Section 1129(b) states only the minimum
14 requirements that must be satisfied for a plan to be fair and
15 equitable. A plan may fail to be fair and equitable in a more
16 general sense even if it satisfies the requirements of section
17 1129(b). In re D & F Const. Inc., 865 F.2d 673 (5th Cir. 1989).
18 I determine that the 600 Alabama plan is not fair and equitable in
19 that more general sense.

20 First, the 600 Alabama plan unduly delays full payment of
21 LAFCU and Redwood Mortgage. The plan provides that the Property
22 need not be sold for five years, without curing even the monetary
23 defaults under the LAFCU and Redwood Mortgage notes. It is not
24 inappropriate for the plan to provide for the sale of the Property.
25 If the third deed of trust is avoidable, there might be some
26 proceeds after payment of property taxes, LAFCU, Redwood Mortgage,
27 and costs of sale, even at a sale price close to the value
28 indicated by the LAFCU appraisal. The 600 Alabama plan, however,

1 seeks not to secure the full value of the Property in the current
2 real estate market, but to hold the Property until the real estate
3 market rises. It is unknowable when, or whether, such a rise will
4 occur. I determine that any plan (or sale procedure outside of a
5 plan) must provide for the sale of the Property as promptly as is
6 commercially reasonable.

7 Second, the 600 Alabama plan deprives LAFCU and Redwood
8 Mortgage of some of their collateral without providing a
9 replacement lien or other adequate protection.

10 All parties acknowledge that the rent payable under the
11 current lease is above the current market rate. The value of all
12 income-producing real property is determined by discounting to
13 present value the expected cash flow from the property. The value
14 of 2712 Mission is enhanced to the extent that the rent from the
15 current lease is above-market. As the above-market portion of the
16 rent is collected, however, some of that value is turned into cash
17 and the value of the real property collateral declines
18 correspondingly.

19 LAFCU and Redwood Mortgage currently have a lien on all
20 rents, including the above-market portion of the current rent. The
21 600 Alabama plan proposes to strip the lien on the current above-
22 market rental income to the extent that this current rental income
23 exceeds the amount necessary to pay current debt service. 600
24 Alabama Plan: §§ 5.2; 7.3.4; 7.5; Exh. A, ¶ 6. Thus, the plan
25 would deprive the secured creditors of some of the value of their
26 collateral, without providing a replacement lien or other adequate
27 protection.

28 There can be no assurance that LAFCU and Redwood Mortgage

1 ultimately will be paid in full from the sale of the Property.
2 Counsel for 600 Alabama acknowledged at the hearing that if the
3 City does not exercise its option to extend the lease, and rent is
4 reduced to market rate, rental income will not be sufficient to pay
5 debt service on the first and second deeds of trust, and the
6 secured creditors will have to be allowed to foreclose. Because
7 any purchaser will determine the value of the Property from its
8 discounted expected cash flow, 600 Alabama's acknowledgment is
9 tacit recognition that if rental income reverts to market, it is
10 unlikely that the Property could be sold at a price sufficient to
11 pay off the first and second deeds of trust.

12 I determine that any plan (or program for sale of the Property
13 without a plan) must sequester and hold for LAFCU and Redwood
14 Mortgage all rental income that is not paid to those lenders or
15 expended on necessary maintenance.

16 C. Secured Creditor's Motion for Relief from Stay

17 There may be equity in the Property from which unsecured
18 creditors may be paid in part or in full. The circumstances
19 suggest MKA may release its third-priority deed of trust for
20 \$50,000. The sum due for property taxes and on the first and
21 second deeds of trust is approximately \$11 million. LAFCU's
22 appraisal indicates that the Property had a value of \$11.2 million
23 in October 2009. Debtor's appraisal indicates that the Property
24 was worth \$13.3 million in March 2009. The proceeds of sale
25 available for secured and unsecured creditors would, of course, be
26 reduced by cost of sale.

27 The value of the Property can reliably be determined only in a
28 sale. A market transaction is always a more accurate indication of

1 value than a court determination made on the basis of appraisals.
2 Romley v. Sun Ntl. Bank (In re Two "S" Corp., 875 F.2d 240, 243
3 (9th Cir. 1989); Takasaki v. Alpine Group, Inc. (In re Alpine
4 Group, Inc.), 151 B.R. 931, 935 (9th Cir. BAP 1993). That is
5 especially so here, where the value of the Property depends heavily
6 upon: (1) whether the City will exercise its option to extend the
7 lease at a rent that all parties agree is above-market; or (2)
8 whether the City will instead attempt to negotiate an amended lease
9 under which the owner and the City share the expenses the City
10 would incur in moving to another location; and (3) what such a
11 negotiated rent would be. At the same time, there is little reason
12 not to determine the value of the Property via sale. Debtor has
13 been unable to confirm a plan under which it would retain the
14 Property, despite ample opportunity to do so. The current rent is
15 sufficient to pay taxes, maintenance, and debt service to LAFCU and
16 Redwood Mortgage pending a prompt sale.

17 Sale of the Property without confirmation of a chapter 11 plan
18 would reduce cost and delay, without sacrificing creditors' rights.
19 A mechanism can be fashioned whereby unsecured creditors, as well
20 as the Debtor, can move to have the estate accept an offer to
21 purchase. Creditors and the Debtor can be heard at the hearing on
22 any such motion. Secured creditors would enjoy the right to credit
23 bid at any sale. The process of confirming a liquidating plan in
24 this case would be very expensive and would provide creditors
25 little corresponding benefit.

26 The Property should be sold promptly. A third-party purchaser
27 or foreclosing lienholder should obtain the Property with
28 sufficient time to negotiate with the City regarding the extension

1 of the lease before the City must exercise its option on April 3,
2 2011. To afford the new owner sufficient time to evaluate the
3 situation and negotiate with the City, any sale must close before
4 the end of 2010. Such a deadline should afford the estate
5 sufficient time to market the Property in a commercially reasonable
6 manner.

7 Therefore, the court at this time denies the secured
8 creditors' joint motion for relief from stay, on condition that the
9 Property be marketed actively and sold promptly, which condition is
10 set forth in greater detail in the accompanying order.

*** *END OF MEMORANDUM* ***

MEMO RE DISC. STMT. OBJECTIONS
AND STAY RELIEF MOTIONS

- 13 -

Court Service List

3 Scott H. McNutt, Esq.
Marianne Dickson, Esq.
4 McNutt Law Group LLP
188 The Embarcadero, Suite 800
5 San Francisco, CA 94105

6 Merle C. Meyers, Esq.
Meyers Law Group, P.C.
7 44 Montgomery Street, Suite 101
San Francisco, CA 94104

8
9 Jeanne M. Jorgensen, Esq.
Page and Jorgensen LLP
10 1101 Dove Street, Suite 220
Newport Beach, CA 92660

11 Henry Lerner, Esq.
Allen Matkins Leck Gamble
12 Mallory & Natsis LLP
13 Three Embarcadero Center, 12th Floor
San Francisco, CA 94111-4074

14 Timothy J. Gorry, Esq.
Gorry, Meyer & Rudd LLP
15 2049 Century Park East, 21st Floor
Los Angeles, CA 90067

16 Hutchison B. Meltzer, Esq.
17 Weiland Golden Smiley Wang
Ekwall & Strok LLP
18 650 Town Center Drive, Suite 950
Costa Mesa, CA 92626

19
20
21
22
23
24
25
26
27
28